No. 84-1447

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

WILLIAM Z. SALCER, *et al.*,

Petitioners,

vs.

ENVICON EQUITIES CORP., *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

RESPONDENTS' JOINT BRIEF IN RESPONSE TO THE BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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Respondents Envicon Equities Corp., Envicon Development Corp., Envitex Realty Corp., Venture Development Group, Inc., U.S. Southwest Associates, Turning Block Associates, Feit & Ahrens, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow and Blonder, Seymour & Shapss jointly submit this brief in response to the brief for the United States as *amicus curiae* (the "Government's brief") and in opposition to the petition for a writ of *certiorari* seeking review of the decision of the United States Court of Appeals for the Second Circuit in *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (1984) ("*Salcer*").

ARGUMENT

The Government's brief, while characterizing the issue presented herein as a "recurring issue of substantial importance to both the government and private parties" (Gov. Br. 4), does little more than reiterate the arguments that were presented to the Second Circuit below (and to the Eighth Circuit sitting *en banc* in *Austin v. Loftsgaarden*, 768 F.2d 949 (8th Cir. 1985) (*en banc*), *pet. for cert. pending sub nom. Randall v. Loftsgaarden*, No. 85-519) ("*Loftsgaarden*") by the SEC and the Tax Division of the Justice Department, as *amici curiae*. Those arguments were incorrect when asserted below, and reiteration here does not make them any more persuasive. Each of those arguments was fully considered by the Second Circuit and, in a well-reasoned decision, was properly rejected.

More important, however, the Government's brief virtually ignores the question put to it by the Court, that is, whether the issue presented by the *Salcer* case is appropriate for consideration by the Court. In the view of respondents, such a review is not warranted. There is no conflict among the circuits (indeed, as shown in Point II, only two of the circuits have considered the precise issue), and only now are the lower courts beginning to explore the manifold fact patterns in which the issue may arise, thus making a review by the Court at this time premature.

POINT I

THE ISSUE PRESENTED IS NOT OF SUBSTANTIAL IMPORTANCE TO THE GOVERNMENT

In asserting that the issue presented here is of "substantial importance" to it, the Government argues that the decision below will destroy the incentives for private enforcement of the securities laws and will have an adverse effect upon the United States Treasury. Both of these arguments are meritless.

First, the incentives for private enforcement of the securities laws operate by encouraging those who have actually been

damaged to seek compensation. This policy of compensation for economic injury has been enacted into law in Section 28(a) of the Securities Exchange Act, which limits recovery of private plaintiffs in actions under the Act to their "actual damages." 15 U.S.C. §78bb(a). *See Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981). The Government offers no principled reason for ignoring the statutory standard requiring "actual damages" and fails to explain why sufficient incentives for private enforcement of the securities laws are not established by providing full redress to investors who have suffered some real economic injury. In addition, the Government ignores the substantial and unjustifiable cost to society and the judiciary in burdening the federal courts with suits by those who have not suffered any real economic injury.

Second, the adverse effect on the Treasury claimed by the Government results not from the decision below but from the tax benefits awarded in accordance with the conscious design of Congress as reflected in the Internal Revenue Code. In providing substantial tax incentives, Congress sought to encourage real estate development to achieve various public policy goals, such as the creation of jobs and the expansion of the housing market and the local tax base. Thus, as the Second Circuit correctly recognized, when the Greenspoint Project involved in the present case was built, the public was benefited and the Government got exactly what it bargained for.[1] (App. 12a)

Since the Government has failed to offer a persuasive explanation of the importance to it of this case, this Court should not heed the Government's call for review. Accordingly, the petition for a writ of *certiorari* in *Salcer* should be denied.

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[1] The Eighth Circuit *en banc* in *Loftsgaarden* agreed completely with the Second Circuit on this point. 768 F.2d at 956.

POINT II

THE GOVERNMENT INCORRECTLY ASSERTS A CONFLICT AMONG THE CIRCUITS

The Government's assertion that a conflict exists among the circuits (Gov. Br. 4-5) totally ignores the critical distinction between actual rescission and rescissionary damages.[2]

Actual rescission is a remedy that entirely undoes the legal effect of a transaction and restores the parties to their status prior to the transaction. Tax shelter investors seeking an award of actual rescission would be required to reconvey their partnership interests to the promoters and would receive back their original purchase price (less amounts received in the course of their partnership participation).

In sharp contrast, the remedy of rescissionary damages is available only if actual rescission has been made impossible by the sale to third parties of their partnership interests. *See* 5C A. Jacobs, *Litigation and Practice under Rule 10b-5* §260.03(c)(vi)(A) (2d ed. 1984). Rescissionary damages are measured by the amount of the original investment less the value of all benefits received by plaintiffs as a result of their investment. *See* Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 Geo. L.J. 1093, 1159-60 (1977).

As a matter of tax law, a judicial declaration of actual rescission might necessitate the filing of amended returns by the investors. While this is far from certain, *see Holbrook v. Commissioner*, 34 TCM 1283 (CCH) (1975), the Internal Revenue Service might contend that an order declaring the rescission of tax shelter investments would require a recomputation of prior "open"

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[2] The Government's assertion (Gov. Br. 5n.3), for which it cites no authority, that there is no legal significance to this distinction is mere *ipse dixit*.

years'[3] tax returns reflecting items attributable to the rescinded investment and payment of all of the taxes (plus interest) which would have been payable if the taxpayer had never invested in the venture.

In this case, in which rescissionary damages are claimed, if such damages were awarded, the investors would *not* need to file amended returns undoing all of the tax benefits they have heretofore received. At worst, they would merely have to declare their recovery as ordinary income in the year of receipt.[4] *See* 1 J. Mertens, *Law of Federal Income Taxation* §7.34, ch. 7, at 115 (1981).

The Government, without any analysis or authority (Gov. Br. 5n.3), cavalierly dismisses this important distinction and argues that the Ninth Circuit's decision in *Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984) conflicts with the Second Circuit's decision below in *Salcer* and the Eighth Circuit's *en banc* decision in *Loftsgaarden*. However, unlike *Salcer* and *Loftsgaarden*, *Burgess* dealt with the tax benefit issue in the context of a claim for actual rescission.

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[3] An "open year" is any tax year as to which the statute of limitations has not run and, therefore, is subject to audit by the IRS. Under Internal Revenue Code Section 6501, a tax year is generally considered "closed" three years after the return for that year has been filed. 26 U.S.C. §6501. Accordingly, it appears that the five years relating to the Greenspoint Project, 1977-1981, are now "closed."

[4] There might be taxes due on the damage award itself in the year in which it is received which may be treated for tax purposes in either of the following ways:

1) *Capital Gains.* If the assets had been previously sold, as in the case of Greenspoint, the investors could treat the damage award as additional "capital gains" from their investment pursuant to Section 741 of the Internal Revenue Code. 26 U.S.C. §741.

2) *Ordinary Income.* Under the "tax benefit" rule, a taxpayer may be required to treat as "ordinary income" any monies received with respect to the tax shelter which constitutes the return of amounts previously deducted against ordinary income. *See Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983).

It is clear from the facts in *Burgess* that, contrary to the Government's contention (Gov. Br. 5n.3), rescission of the challenged investments was, indeed, still possible. As stated by the Ninth Circuit in *Burgess*:

> After losing money for several years on their investments, four of the [plaintiffs] sold their herds *back to Premier* [the promoter], and one disposed of his herd on the open market. * * * [¶] In 1978 the five [plaintiffs] filed this action against Premier.

727 F.2d at 830 (emphasis added). It is thus plain that the Second and Eighth Circuits correctly distinguished *Burgess*, since four of the five plaintiffs there sought actual rescission. Having already partially undone the original transaction by selling the herds back to Premier (the promoter), those four plaintiffs then sued Premier to undo the transaction completely, *i.e.*, to recover the remainder of their investment. Upon conclusion of the litigation, those plaintiffs would indeed have achieved actual rescission: Premier would have its herds once again, and the plaintiffs would have all their money.

In any event, whatever the appropriate damage theory for that lawsuit, the Ninth Circuit manifestly *believed* it was deciding a case of actual rescission, as indicated by the following three quotations from the *Burgess* opinion (emphasis added):

> "*Rescission* was an appropriate remedy for the [plaintiffs'] claims." 727 F.2d at 837.

> "*Rescission* voids the transaction and returns to both parties the consideration they paid." *Id.*

> "*Rescission* is accomplished by returning to [plaintiffs] the $496,128 which the jury found and Premier et al. concede to be the out of pocket loss." *Id.*

It is further apparent from the *reasoning* of the Ninth Circuit's decision that the *Burgess* court believed it was deciding a case of actual rescission. The court twice stated that a judgment

in plaintiffs' favor would require them to file amended returns for prior years, thus, presumably, undoing all of the deductions taken in those years. *Id.* at 838. As shown above, as a matter of tax law, in cases such as *Salcer* and *Loftsgaarden*, involving claims for rescissionary damages, there would be no need to go back to amend prior years' returns for recomputation or elimination of the tax benefits received in those years.

The *Burgess* decision, therefore, is not in conflict with either *Salcer* or *Loftsgaarden*. There being no conflict among the circuits, the petition for a writ of *certiorari* should be denied.

POINT III

THIS ISSUE IS PREMATURE FOR REVIEW

The precise issue here has been decided by only the Second and Eighth Circuits, and both decisions involved real estate tax shelter investments.[5] This is significant because the Government relies on the argument that the investors' tax benefits were illusory (Gov. Br. 7-11) and the permanence of these tax benefits may well depend upon the specific sections of the Internal Revenue Code that are involved. The multifarious varieties of tax shelter investments in the marketplace – cattle deals, publishing and movie deals, franchise deals, oil and gas deals, and coal deals, to name but a few – involve different sections of the Code from real estate deals, and the issue of reducing rescissionary damage awards by the amount of the net tax benefits received has not been considered by the circuit courts in any of those contexts. This Court, therefore, should decline review until further consideration has been given the issue by other circuits and in other factual and legal contexts.

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[5] As shown above in Point II, *Burgess*, which involved a cattle tax shelter, did not decide the precise issue in this case. In *Freschi v. Grand Coal Venture*, 767 F.2d 1041 (2d Cir. 1985), *pet. for cert. pending*, No. 85-377, which involved a coal lease tax shelter, the court was considering tax deductions taken by the investors which did not arise out of the operation of the tax shelter, as they did here and in *Loftsgaarden*.

As three Members of this Court have noted in explaining their vote to deny *certiorari* in another case:

> I believe that further consideration of the substantive and procedural ramifications of the problem by other courts will enable us to deal with the issue more wisely at a later date.

McCray v. New York, 461 U.S. 961, 962 (1983) (opinion of Stevens, J., joined by Blackmun and Powell, JJ., respecting the denial of *certiorari*). Moreover, it is "a sound exercise of discretion" to allow the various circuits to "serve as laboratories in which the issue receives further study before it is addressed by this Court." *Id.* at 963.

The benefits of withholding review at this stage are significant. Should other circuits concur in the result reached by the Second and Eighth Circuits, the law will remain uniform, and this Court will be able to devote its scarce judicial resources to issues that truly require resolution by the Court. On the other hand, should other circuits disagree with the conclusion of Second and Eighth Circuits, this Court will have the benefit of additional judicial consideration and analysis of the issue when it accepts review.

Accordingly, contrary to the Government's view (Gov. Br. 12-13), the petitions for writs of *certiorari* should be denied in both *Salcer* and *Loftsgaarden*.

POINT IV

IF REVIEW IS GRANTED IN LOFTSGAARDEN OR FRESCHI, REVIEW SHOULD BE GRANTED HEREIN

Notwithstanding Points I-III, if this Court accepts the Government's request and grants review in *Loftsgaarden* or *Freschi v. Grand Coal Venture*, No. 85-377,[6] it should also grant review in *Salcer* because *Salcer* presents one of the strongest possible fact situations in favor of reducing a rescissionary damage award in tax shelter litigation by the amount of the tax benefits received by the investors.

As the Second Circuit acknowledged, there is no dispute among the parties in *Salcer* that the tax benefits claimed by petitioners were legal and in the correct amount. (App. 4a-5a) Moreover, none of these benefits are still subject to "recapture," since recapture would already have occurred upon sale of the project in 1981.[7]

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[6] In *Freschi*, the Second Circuit held that an award of damages had to be reduced by the amount of the tax deduction claimed. Those tax deductions did not arise out of the operation of the tax shelter, but rather were ordinary business deductions claimed as a result of the *loss of the investment*. Inasmuch as the fact situation in *Freschi* is completely different from that in *Salcer*, which solely involves bargained-for tax benefits arising directly out of a tax shelter project, respondents herein take no position on the merits in *Freschi*.

[7] In rejecting arguments made by the SEC and the Tax Division that plaintiffs' tax benefits might not be permanent and thus should be ignored, the Second Circuit stated (App. 15a-16a):

> Despite the fact that plaintiffs took the deductions during the period from 1977-81, thereby giving the I.R.S. several years to challenge them, it has not sought to disallow them. Indeed, the government merely speculates that it "*may*" challenge them some time in the future and that it is possible that they "*could* be denied in whole *or in part*" (emphasis added). Brief at 5. * * * If the I.R.S.'s position is that the plaintiffs are not entitled to the tax benefits they took, its duty is to disallow the deductions rather than attempt to place the issue in limbo indefinitely. Despite ample time for an audit and initial decision it has failed to act.

(App. 16a) Finally, petitioners agree that they already have received a substantial net gain in the transaction, even without taking into account their prospective recovery in this action. They have invested $77,500 per unit and have already received $30,000 per unit from the sale of the project and $67,866 per unit in net permanent tax benefits, for a total of $97,866 per unit. (App. 4a-5a, 14a) Any additional recovery received by way of damages would only result in a *further* net benefit to petitioners, whether or not such recovery is taxable.

Should this Court choose to review the tax benefit damage issue in either *Loftsgaarden* or *Freschi*, it should have before it the facts presented in the *Salcer* case, as well.

CONCLUSION

The petition for a writ of *certiorari* should be denied, notwithstanding the Government's arguments. If, however, *certiorari* is granted in *Loftsgaarden* or *Freschi*, *certiorari* should also be granted here.

Respectfully submitted,

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